

STATE OF NEW YORK
DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
R & V COMPANY	:	DETERMINATION
	:	DTA NO. 812213
for Revision of a Determination or for Refund of Tax on	:	
Gains Derived from Certain Real Property Transfers under	:	
Article 31-B of the Tax Law.	:	

Petitioner, R & V Company, c/o Howard M. Koff, Esq., 600 Broadway, Albany, New York 12207, filed a petition for revision of a determination or for refund of tax on gains derived from certain real property transfers under Article 31-B of the Tax Law.

On September 26, 1996 and October 9, 1996, respectively, petitioner, represented by Howard M. Koff, Esq., and the Division of Taxation, represented by Stephen U. Teitelbaum, Esq. (Paul A. Lefebvre, Esq., of counsel), agreed to waive a hearing and have the matter determined on submission of documents. Petitioner filed its brief and documents on November 14, 1996. The Division of Taxation filed its brief on January 22, 1997. By letter dated January 28, 1997, petitioner stated that after reviewing the Division of Taxation's brief, it deemed it unnecessary to file a reply brief. Therefore, the filing of petitioner's letter on January 28, 1997 began the six-month period for the issuance of this determination.

Upon review of the entire record, Marilyn Mann Faulkner, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether "consideration" includes the full amount outstanding on a second mortgage, plus accrued interest on that mortgage, on a foreclosure transfer of the real property when the mortgage indebtedness exceeds the fair market value of the property and the mortgagor assumes no personal liability on the mortgage debt.

II. Whether the original purchase price, as defined in Tax Law § 1440(5), includes legal

fees incurred to challenge the zoning classification of the real property.

FINDINGS OF FACT

1. On November 8, 1996 and November 13, 1996, respectively, the Division of Taxation and petitioner R & V Company, signed a stipulation of facts which have been incorporated into the following findings of fact.

2. Petitioner R & V Company ("R & V") owned real property located in the Town of Huntington, Suffolk County. As of July 17, 1991, R & V owed, on a first mortgage held by the Estate of John Froehlich, \$7,000,000.00 in principal and \$1,130,116.44 in unpaid interest for the total amount of \$8,130,116.44. At the same time, Reliance Federal Savings Bank held a second mortgage on the same property for the approximate amount of \$6,500,000.00 which included accrued interest. The second mortgage was not a purchase money mortgage and was nonrecourse with no personal liability on the part of R & V.

3. Reliance Federal Savings Bank foreclosed on the second mortgage. The real property was transferred on foreclosure on July 16, 1991. On the transferor questionnaire, R & V listed Reliance Federal Savings Bank as the transferee and \$8,130,116.00 (the amount on the first mortgage) as the gross consideration to be paid by the transferee for the transfer. R & V stated that it did not include the amount of the second mortgage as "consideration" on the questionnaire because the second mortgage was not a purchase money mortgage and R & V had no personal liability on that mortgage. Therefore, asserted petitioner, it was not receiving any value from the discharge of the second mortgage in foreclosure.

4. On the transferor questionnaire, R & V also included in its original purchase price legal fees in the amount of \$1,250,000.00 as the cost of capital improvements to the real property. The parties stipulated that these legal fees were incurred to challenge the existing zoning classification of the property to allow for higher density residential development. The parties stated that these fees were never paid by petitioner and that, due to the transfer in foreclosure, petitioner never had a chance to develop the property which instead remained in the same physical condition from the time it was acquired until the time it was transferred.

5. Reliance Federal Savings Bank subsequently sold the real property to The Nature Conservancy on October 31, 1991 for \$12,425,000.00, substantially less than the combined amount owed by petitioner on the first and second mortgages.

6. The Division of Taxation ("Division") sent to petitioner a Schedule of Adjustments, dated January 21, 1992, concerning its transfer of the real property to Reliance Federal Savings Bank. In that statement, the Division informed petitioner that it was disallowing certain amounts claimed as capital improvement costs, including legal fees. The Division also stated that the amount due on the second mortgage (\$6,847,507.96) was to be included as consideration for the transfer of the property.

7. The Division issued to petitioner a Notice of Determination, dated September 21, 1992, for tax due in the amount of \$602,957.97, plus \$64,903.92 in interest and a \$211,035.16 penalty, for the total amount of \$878,897.05.

8. After a conciliation conference, the conferee issued a conciliation order, dated August 20, 1993, sustaining the statutory notice.

9. R & V filed a petition, dated August 26, 1993, challenging the notice of determination. Petitioner argued that the Division erred by including the full amount of the second mortgage as "consideration" and that the Division erred in disallowing the legal fees as part of the original purchase price. Petitioner noted that the fair market value of the property was substantially less than the combined amount of the first and second mortgages; that the foreclosure resulted in a loss rather than a gain; and that the legal fees were incurred to convert the property "from raw land to approved development status", and as a result, the value of the property was enhanced substantially.

10. The Division filed an answer, dated October 21, 1993, affirmatively stating that the transfer of real property resulted in gain which was subject to the real property transfer gains tax, and that petitioner has the burden of proving that the Division's determination was improper.

11. In its letter brief, petitioner argues that because it was free to "walk" away from the

indebtedness of the second mortgage, the foreclosure on the second mortgage did not give it something of value, and therefore, it was not in receipt of any consideration with respect to the foreclosure on the second mortgage.

12. Citing Kalikow-Yaphank Development Corp. v. Tax Appeals Tribunal (__ AD2d __, 651 NYS2d 647) and Matter of Shed Development Corp. (Tax Appeals Tribunal, October 26, 1995), the Division argues that there is strong precedent to support the Division's position in this case.

CONCLUSIONS OF LAW

A. Tax Law former § 1441 imposes a tax on gains derived from the transfer of real property at the rate of 10% of the gain.¹ Tax Law former § 1440(3) defines "gain" as the difference between the consideration for the transfer of real property and the original purchase price. Under the statute, "consideration" is defined as:

"the price paid or required to be paid for real property or any interest therein Consideration includes any price paid or required to be paid, whether expressed in a deed and whether paid or required to be paid by money, property, or any other thing of value and including the amount of any mortgage, purchase money mortgage, lien or other encumbrance, whether the underlying indebtedness is assumed or taken subject to. Consideration includes the cancellation or discharge of an indebtedness or obligation." (Tax Law § 1440[1][a]; emphasis added.)

Petitioner asserts that because the second mortgage was nonrecourse, it was free to "walk away" from its indebtedness on the second mortgage, and therefore, the amount owed on the second mortgage should not be included as consideration in the transfer of the real property on foreclosure of the second mortgage. As noted by the Division, the Tax Appeals Tribunal has addressed this very same issue in Matter of Shed Developers (*supra*). In that case, the taxpayer transferred real property to the mortgagee holding a mortgage on the property in lieu of foreclosure. The mortgage indebtedness to the mortgagee was nonrecourse and the taxpayer argued that because the mortgage indebtedness discharged by the transfer in lieu of foreclosure exceeded the fair market value of the property at the time of its transfer,

¹Tax Law §§ 1440 to 1449-c were repealed, effective July 13, 1996 and applicable to all transfers occurring on or after June 15, 1996 (L 1996, ch 309).

the consideration for the transfer was limited to such fair market value. The Tax Appeals Tribunal held that based on Tax Law § 1440(1)(a), consideration for gains tax purposes includes the amount of mortgage indebtedness discharged as a result of the transfer regardless of whether the indebtedness involved a recourse or nonrecourse mortgage.

Contrary to petitioner's contention that the facts in Matter of Shed Developers are distinguishable, the holding in Matter of Shed addresses the same relevant facts and issue. Inasmuch as R & V's debt obligation under the second mortgage was discharged when the property was transferred at foreclosure, the outstanding debt and accrued interest under the second mortgage should have been included as "consideration" for the property transferred to Reliance Federal Savings Bank for gains tax purposes.

B. With respect to the second issue, the statute defines "original purchase price" as:

"the consideration paid or required to be paid by the transferor; (i) to acquire the interest in real property, and (ii) for any capital improvements made or required to be made to such real property, including solely those costs which are customary, reasonable, and necessary, as determined under rules and regulations prescribed by the tax commission, incurred for the construction of such improvements. Original purchase price shall also include the amounts paid by the transferor for any customary, reasonable and necessary legal, engineering and architectural fees incurred to sell the property . . ."(Tax Law former § 1440[5][a]).

On the transferor questionnaire, R & V asserted that the legal fees were incurred as a capital improvement cost. According to the stipulated facts, the legal fees were incurred to change the zoning status of the real property to allow for higher density residential development. In brief, petitioner addresses this issue in a footnote stating that the original purchase price issue is pending before the Appellate Division in Matter of Kalikow-Yaphank Development Corp. v. Tax Appeals Tribunal.

After petitioner filed its brief, the Appellate Division rendered a decision in that case on December 12, 1996 (Matter of Kalikow-Yaphank Development Corp. v. Tax Appeals Tribunal, ___ AD2d ___, 651 NYS2d 647). In that decision, the Appellate Division held that legal, architectural and engineering expenses incurred by the taxpayer to obtain subdivision approval after the purchase of the property cannot be included as part of the original purchase price in a subsequent sale of the real property. The Court stated that the plain language of the statute

required that the original purchase price include only expenses paid to create an ownership interest in real property and not costs incurred after the acquisition of the property (Matter of Kalikow-Yaphank Development Corp. v. Tax Appeals Tribunal, *supra*, 651 NYS2d at 648-649). The Court further noted that although the expenses incurred by the taxpayer in obtaining subdivision approval was a factor in arriving at the subsequent sale price of the property, the Tax Appeal Tribunal's interpretation of Tax Law § 1440(5)(a) to exclude these expenses from the original purchase price was not unreasonable. Therefore, based on the holding in Kalikow-Yaphank, petitioner may not include these legal fees as part of the original purchase price.

C. The petition of R & V Company is denied and the Notice of Determination, dated September 21, 1992, is sustained.

DATED: Troy, New York
May 22, 1997

/s/ Marilyn Mann Faulkner
ADMINISTRATIVE LAW JUDGE